



SUMMARY
MICHIGAN CHAMBER OF COMMERCE
ANALYSIS OF GOVERNOR'S TAX PLAN, PART ONE

March 29, 2005

On January 27, 2005 Governor Granholm unveiled her business tax restructuring plan where she recommended 13 changes in tax policy. Two weeks later the Governor released her proposed 2005/2006 Executive Budget with another nine changes in tax policy and a liquor fee increase proposal. The attached document provides an analysis of Part I of the overall changes in tax policy the Governor has recommended, specifically the "tax restructuring" proposals. Part II will focus on the tax policy changes contained within the Budget recommendation and will be provided under separate cover.

Review Process

Following the release of the Administration's proposal over 70 Michigan Chamber Tax Committee members and other members from around the state, listened to a presentation by State Treasurer Jay Rising and reviewed and analyzed each proposal.

Findings

We agree that a Single Business tax (SBT) rate reduction is a good idea and that providing manufacturers with a personal property tax credit would be a step in the right direction. Incentives to encourage research and development are also positive proposals and should be welcomed. We support decreasing the tax burden on Michigan companies by changing the SBT apportionment formula.

Unfortunately, the remaining proposals would substantially increase the tax burden on many Michigan businesses. This tax shift plan would increase taxes by tripling the profit component of the tax base calculation, eliminating long-standing provisions of the SBT that reduce the tax burden carried by labor-intensive industries, and restrict the availability of tax relief for small businesses. This plan would also significantly increase the tax burden on insurance companies. Finally, this would undermine Proposal A by overturning a unanimous Michigan Supreme Court decision that reaffirmed that property tax assessment increases cannot exceed the constitutional cap of inflation or 5%, whichever is less. This would result in significant tax increases on commercial property owners and individuals and families who own rental property.

In addition, the Administration is masking the fact that they have proposed a "tax restructuring" plan that will likely be challenged in court by out-of-state companies. (Their hidden "acknowledgement" of this is demonstrated in the inclusion of a complicated "fallback" tax provision in the event a court rules against the state.) Our preliminary analysis of the Governor's tax shift plan, by the companies that pay business taxes, also raises serious questions about the accuracy of the Administration's revenue estimates and casts doubt on the Governor's claim that her proposal would be 'revenue neutral' on a statewide basis.

Conclusion

While several of the proposed changes advocated by the Governor would appear to benefit some manufacturers, other proposals advocated by the Governor would result in major tax increases for many of Michigan's job providers – including certain manufacturers, retailers, wholesalers, utilities, professional service providers, commercial property owners, banks and others. The Michigan Chamber strongly supports tax relief for manufacturers and other job providers. We are unalterably opposed to tax increases on other job providers and we urge the Legislature to reject them.

For further information or if you have any questions, please call Tricia Kinley or Rich Studley at (517) 371-2100.

Michigan Chamber of Commerce Analysis
of
Governor's Tax Restructuring
Updated April 18, 2005

Please note: This document will be updated periodically to reflect more analysis as it is received.

Administration's Description of Changes in Tax Policy	What This Proposal Really Does	Status	Treasury Revenue Estimate (millions)	Michigan Chamber Position	Explanation
Legislative Finding, Provides legislative finding that reducing the tax rate, broadening the base, and increasing reliance on positive business income improves the measurement of value added, and maintains the tax as a modified value added tax.	Masks the fact that the Administration has put forth a proposal that will likely be challenged in court by out-of-state companies.	SB 296 HB 4476			<p>This statement casts a shadow of doubt about whether the Administration believes their proposal will be upheld in court.</p> <p>By tripling the tax on profits, the SBT may be moving away from its status as a value added tax, which currently permits the Dept. to utilize a broad, physical presence nexus standard. If the SBT were deemed to be a tax on income, a much more stringent nexus standard would apply, and the Dept would lose the ability to impose the SBT on so many out-of-state businesses and therefore lose revenue.</p> <p>This should be viewed as a red flag for all taxpayers, and unfortunately will likely be viewed by out-of-state companies as an invitation to sue the state of Michigan.</p> <p>Furthermore, while this statement is "intended" to alleviate doubt about the constitutionality of this proposal, one only needs to turn to page 17 to find an alternative "tailback" tax provision in the event the state loses in court. This begs the question "how much will it cost the taxpayers of Michigan to defend this proposal in court?"</p>

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1. Cutting the Rate for All SBT Taxpayers – the rate would be reduced from 1.9% to 1.2 % and 2% to 1.2% for the small business calculation	Provides broad-based tax relief.	SB 296 HB 4476	Decrease taxes by \$700 million	Support	The Michigan Chamber has consistently advocated for broad-based tax relief that benefits a wide range of business taxpayers. While profits would be taxed at an effective rate of 3.6%, this proposed reduction would benefit all businesses by reducing the tax rate on the add back of compensation and benefits; depreciation and interest expense. <u>This would benefit all taxpayers.</u> However, the proposed reduction in the small business credit tax rate from 2% to 1.2% may not be significant for many taxpayers, as in order to qualify for the credit a business must have adjusted business income of less than \$475,000. Thus, if adjusted business income were at its maximum, the maximum tax reduction may not be great.
2. Creating a Manufacturing Personal Property Tax Credit – manufacturers would get a credit for 35% of personal property taxes paid on property used for manufacturing and R&D purposes	This provides a refundable SBT credit for 35% of personal property taxes paid. Does nothing to actually lower personal property taxes or alleviate the administrative burden of ppt filing.	SB 296 HB 4476	Decrease Taxes by \$250 million	Support concept. Oppose linking/tie-barring. Should move as a stand-alone measure.	The Chamber has consistently advocated for relief from personal property taxation. Chamber policy calls for substantially reducing or eliminating personal property taxes due to the very high property tax burden in Michigan. Technically, this is not a "personal property tax credit," rather it is an SBT credit for personal property taxes paid (apparently to be refundable.) However, this is considered a step in the right direction. The Michigan Chamber believes this type of relief should be extended to all Michigan job providers. Questions and concerns that have been raised include: - In what order would the refundable credits and loss carryforwards be taken? This could impact the actual "value" of the credit. -How the definition of "manufacturer" and "property used for manufacturing and R&D purposes" will be defined. <u>This is a tax cut that would tend to benefit manufacturers.</u>

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3. Changing to 100% Sales Factor Apportionment – the calculation of the Michigan share of the tax base would be based exclusively on the firm's percentage of Michigan sales	Provides an incentive to locate in Michigan.	SB 296 HB 4476	Decrease taxes by \$40 million.	Support Oppose linking/tie-barring. Should move as a stand-alone measure.	<p>The Chamber has consistently supported changing the apportionment factor to benefit Michigan based businesses.</p> <p>The current apportionment formula is 90% sales, 5% payroll, and 5% property, and applies to Michigan-based companies and out-of-state companies. Moving to a 100% sales factor, whereby property and payroll are excluded, would have the effect of decreasing the tax burden on firms that are producing within Michigan and exporting to other states, and increasing the SBT liability for businesses who sell products into Michigan.</p> <p><u>This would favor Michigan-based companies.</u></p>

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4. Increasing the Weight of Profit in the SBT Tax Base – Corporate profits would receive an additional weighting of 2.0	<p>Triplies the profit component when computing the single business tax base.</p> <p>Penalizes job providers for being successful.</p>	<p>SB 296 HB 4476</p> <p>Increase Taxes by \$330 million</p>	Oppose	<p>This would result in a significant SBT increase on many job providers.</p> <p>This provision triple weights the profit (business or taxable income) component of the SBT tax base and would increase the SBT tax base for profitable C-Corp businesses and some LLCs. The impact of an additional weighting of two times, actually results in an effective tax rate on profits of 3.6% (1.2% x 3.)</p> <p>Not only does the triple-profit likely result in a tax increase at face value, but according to Treasury they will not be allowing for a corresponding tripling of certain non-value added components of the tax base, which are currently allowed as a subtraction in arriving at the SBT tax base. In addition, royalty and interest income would be tripled as part of taxable income, but subtracted only once. This imbalance is inconsistent with the theory of the SBT as a Value Added Tax.</p> <p>By tripling the tax on profits, there is a concern that the SBT is moving away from its status as a VAT, which currently permits the Dept. to utilize a broad, physical presence nexus standard. If the SBT were deemed to be would apply, and the Dept would lose the ability to impose the SBT on so many out-of-state businesses and therefore lose revenue.</p> <p>This proposal would tend to hurt profitable companies.</p> <p>Due to the fact that the Administration believes a "fallback" alternative tax provision is necessary in the event a court finds this proposal unconstitutional, this should be viewed as a red flag for all taxpayers, and unfortunately will likely be viewed by out-of-state companies as an invitation to sue the state of Michigan.</p>

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5. Creating R&D Credit – Taxpayers would receive a credit for 1.2% of compensation paid to employees engaged in research and development	Creates an R&D Credit – Taxpayers would receive an SBT credit for 1.2% of compensation paid to employees engaged in research and development	SB 296 HB 4476	Decrease taxes by approx \$15 million.	Support concept. Oppose linking/tie- barring. Should remain stand-alone issue.	<p>The Chamber has consistently advocated for SBT relief due to the very high SBT tax burden on job providers. This is considered a step in the right direction. However, this type of relief should be extended to all job providers who engage in R & D.</p> <p>Questions and concerns that have been raised include: -how "R&D" is defined and which employees are considered "engaged in R&D" - in what order would the refundable credits and loss carryforwards be taken? This could impact the actual "value" of the credit.</p> <p><u>This is a tax cut that would tend to benefit companies engaged in R & D.</u></p>

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6. Eliminating Excess Compensation Reduction	Eliminates a tax filing option that has been an integral part of the SBT since 1975.	SB 296 HB 4476 Increase taxes \$220 million	Oppose	This would be a significant tax increase on many job providers. The Excess Compensation filing method was integrated into the SBT to help mitigate the effect of the high tax on jobs (compensation) that the SBT imposes. Eliminating this method expands the tax base of the SBT. The current law allows for a reduction of the SBT tax base when compensation exceeds 63% of pre-apportioned SBT tax base. The reduction is equal to the percent by which compensation exceeds 63 percent of the tax base, up to a maximum of 37 percent. <u>Elimination of this reduction would increase tax on labor intensive businesses where compensation makes up a substantial portion of the tax base.</u>
7. Eliminating the Gross Receipts Reduction	Eliminates a tax filing option that has been an integral part of the SBT since 1975.	SB 296 HB 4476 Increase taxes \$162 million	Oppose	This would be a significant tax increase on many job providers. The Gross Receipts filing method was integrated into the SBT to help mitigate the effect of the high tax on jobs (compensation) that the SBT imposes. Eliminating this method expands the tax base of the SBT. If a firm's adjusted tax base exceeds 50 percent of adjusted gross receipts, then a firm may use the gross receipts reduction method. The reduction equals the amount that the adjusted tax base exceeds 50 percent of adjusted gross receipts. <u>Many service businesses that have relied on the 50% of gross receipts method would have a substantial increase in their SBT liability.</u>

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8. Eliminate special credit for unincorporated businesses	Increases SBT on many small job providers.	SB 296 HB 4476	Increase taxes \$79 million	Oppose	<p>This is an SBT increase on many small businesses.</p> <p>Currently unincorporated businesses (individuals, LLCs, partnerships and S corporations) receive a 10 to 20% credit against their SBT liability to lessen the impact of double taxation on business income.</p> <p>Although the rate decrease could offset the loss of the unincorporated credit (provided that none of the other revenue increases affects the calculation, such as the elimination of the excess comp reduction), the unincorporated business still pay double tax on a portion of their liability.</p> <p>While the unincorporated entities <i>will</i> have a rate reduction that, in theory, would lead to a tax decrease, the elimination of reductions and filing methods makes overall tax reduction less likely.</p>
9. Eliminate special credit for telephone property taxes paid	Increase SBT on telecommunications providers.	SB 296 HB 4476	Increase \$4 million	Oppose	<p>This would result in an SBT increase on telecommunications providers.</p> <p>The current law allows telephone companies paying the state utility property tax to claim a 5% credit against their SBT liability partially reimbursing them for property taxes paid on assets that are required to be deployed under the federal and State government's universal service mandates.</p> <p>The proposal would eliminate this SBT credit, thereby <u>increasing taxes on the telecommunications industry.</u></p>

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10. Treat compensation of employees leased from a professional employer organization (PEO) as compensation of the client business	Significantly increase SBT on many small, medium, and large, job providers.	SB 296 HB 4476	TBD	Oppose
				<p>This would be a significant SBT increase on many job providers.</p> <p>Currently most PEOs pay SBT based on the 50% of gross receipts method and their employees' compensation is included on their SBT return.</p> <p>If enacted, this proposal would require compensation paid to officers to be included in the tax base of the company for whom the work was being performed, rather than the PEO. This is contrary to recently enacted legislation (PA 603 of 2002), which clarified that PEO employees' compensation should be included on the SBT return of the PEO.</p> <p>Furthermore, this proposal requires that all other employee compensation paid by a PEO that has more than 1 percent common ownership with a client must be included in the tax base of the client. This too is contrary to recently enacted legislation (PA 603 of 2002), which clarified that PEO employees' compensation should be included on the SBT return of the PEO.</p> <p><u>This would hurt many companies who utilize "captive" PEOs for many reasons including administrative functions, workers compensation, and legal liability.</u></p>

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11. Make small business credit eligibility independent of business organization or out of state affiliation	Increases SBT on many Michigan businesses by eliminating the availability of the small business credit for certain limited liability companies.	SB 296 HB 4476 TBD, but in 2002 Treasury estimated a \$ 4.5 million increase.	Oppose	<p>This is an SBT increase and would hurt small business.</p> <p>This proposal would put new restrictions on LLC's ability to qualify for the Small Business Credit. The seed of this problem is that the small business credit qualifying thresholds and corresponding compensation thresholds are outdated. Revising and updating the small business credit might be helpful, but it is an issue that should be addressed separately. Furthermore, Treasury attempted to do this in 2003 under the guise of "loopholes" and the legislature rejected this tax increase.</p> <p><u>This would tend to hurt small businesses who are LLCs.</u></p>
12. Changing the Taxation of Insurers – impose a 2% premiums tax like that imposed by most other states	Significantly increase taxes on insurance providers.	SB 296 HB 4476 Increase taxes \$255 million	Oppose	<p>This would result in substantial tax increases on Michigan-based insurance companies.</p> <p>This proposal would subject Insurance companies to a 2% tax on gross premiums. These companies would also see tax increases due to the elimination of SBT credits provided for the payments made due to state-mandated Guaranty programs. In addition, if enacted, insurance companies would experience increased taxes in states outside of Michigan. The number of states where they pay retaliatory taxes would increase from four to thirty.</p> <p>The Administration said that BC/BS, and HMOs and self-insureds would be exempted from this proposal. This increases the competitive disadvantage felt by for-profit health care insurers.</p> <p>It has been estimated that this new tax would double the taxes (some insurance companies have reported that their liability would actually quadruple) currently being paid by insurance companies in Michigan and amount to an estimated tax increase of far exceeding \$250 million.</p>

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13. Eliminating Special Property Tax Treatment for Commercial Rental Property – Treat changes in value like all other value changes are treated for assessment purposes	Undermines Proposal A and increases taxes on commercial property owners and individuals and families who own rental property.	SB 295 HB 4477	Increase taxes \$60 million	Oppose	<p>This would be a substantial property tax increase on commercial property owners and owners of small rental units (apartments and duplexes.)</p> <p>This would overturn a unanimous Michigan Supreme Court decision (<i>WPW v. City of Troy</i>) that reaffirmed that property tax assessment increases cannot exceed the constitutional cap of inflation on 5%, whichever is less. Furthermore, the City of Southfield has initiated litigation on the very question of the constitutionality of "reduced occupancy" as it relates to losses allowed under the General Property Tax Act. The Governor's proposal would prematurely eliminate the "reduced occupancy" element of calculating taxable value.</p> <p>This would also have the effect of reducing the amount of the Headlee rollback, and is therefore an across-the-board property tax increase on all Michigan taxpayers (including homeowners.) Since "reduced occupancy" would no longer be subtracted in calculating Headlee rollbacks, the rollback would not be as much. That means every millage rate would stay a little higher than otherwise would have occurred, resulting in an across-the-state tax increase. This increase is not included in their revenue estimates.</p> <p>This proposal sets a bad precedent and sends a very negative message to homeowners that their assessment cap may not be guaranteed either. This change would require either a constitutional amendment to Proposal A or at least a 3/4 majority vote in both houses of the legislature since it would be a property tax increase limited under Proposal A of 1994.</p> <p>Furthermore if the income producing property's "true cash value" (SEV is 50% of TCV) decreases because of a decrease in occupancy and the taxable value (over a period of several years may be less than 50%) does not decrease proportionately or remains unchanged from the prior year's taxable value, the taxable value to TCV assessment ratio will increase...causing the "de facto" revaluation without a transfer of ownership.</p>